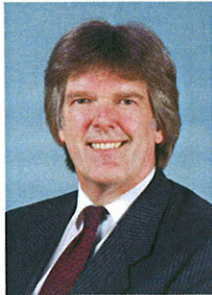




Capital Cranfield Trustees
the balanced view



Allan Course

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Should trustees delegate investment decisions to an adviser?

In a short article, it is very difficult to cover all of the key issues succinctly, so I must be clear what I am trying to achieve, taking account of the constraints I have to work within. That is precisely the approach that Trustees should adopt when considering delegating investment decisions.

First, there is no "one size fits all" solution. The constraints of the trustees of a £50m will differ significantly from those of a £5bn fund. However, a good starting point for any board of trustees would be to assess its investment governance capacity, objectively and honestly. In essence this comprises its collective skills and knowledge, the time it can devote to investment issues and its process for making timely decisions. Although it is not always a comfortable discussion to have, ideally this review should also cover the trustees' collective behavioral-finance characteristics – for example, whether the board is overly change-averse.

The next question is "what, precisely, do we want to delegate?"

There is a very wide range of options. Trustees cannot delegate their responsibility to set the investment objectives and strategy but they could delegate some or all of the following activities: Risk allocation, medium term asset allocation, portfolio construction, exploiting short-term market anomalies, manager hiring & firing, manager monitoring, negotiating manager fees etc.

As a minimum, delegation involves giving the adviser responsibility for hiring & firing managers. Many trustee boards feel uncomfortable about this, saying that they do not like losing control. However, research has shown that institutional investors and pension fund trustees are often poor at manager selection, and actually destroy value. Their natural tendency is to fire a manager following a period of underperformance and replace it by one who is currently performing well. This can be dangerous. A study in the USA involving funds collectively totaling \$6 trillion showed that the managers who were fired outperformed the managers who replaced them by over 2% p.a. over the next five years. One cause relates back to behavioral-finance psychology – it feels right to sack a poor performer, but it feels wrong to





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sack a good performing manager even though this might be the better tactic, in order to capture the outperformance.

This is one good rationale behind delegation – investment professionals should be aware of these inherent behavioral biases and operate more objectively. They should also have a much greater capacity to do ongoing monitoring and research and make swift decisions, unlike most trustee board that only meet quarterly. They should also be able to achieve cost reductions through economies of scale via pooled investments and central negotiation of fees.

As mentioned earlier, a key disadvantage is loss of control and if trustees do intend to delegate some investment duties they must first carry out proper due diligence checks to ensure that the investment adviser has an effective governance infrastructure for strategy, research, risk management and objective decision making. You cannot assume that just because they are a well-known name they must have every component in place!

Finally, there is the matter of their remuneration. My belief is that the contract must make a significant element of their fees performance related, to ensure that their interests really are aligned closely to yours. This means that they should suffer the pains of underperformance as well as enjoy the gains of over performance!

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